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Participation Rights of Preferred Stockholders

By L. L. Briggs

The terms of a preferred-stock contract may provide that after payment of the preferred dividend the holders of this stock may be entitled to share equally with the common stockholders in any further dividends that may be declared or that they may share in dividends declared after the holders of the common stock have received a dividend equal to that of the preferred. The preferred certificate may also prohibit further participation in profits after the holders have received their stipulated dividend.

When there is no provision at all in the preferred contract in regard to the disposition of earnings left after the preferred stockholders are paid their contractual dividend, misunderstandings may arise because the contract may be interpreted as limiting these shareholders to this amount or it may be interpreted as not having such a limitation. Most of the corporate instruments merely state that certain shareholders shall be entitled to a specified preferential dividend and contain no provision as to what shall be done with the balance of the surplus earnings available for distribution as dividends.

Some writers on corporation law and the leading legal encyclopedias state that unless the corporate instruments provide otherwise, preferred and common stockholders participate equally in any distribution of profits after both the preferred and the common shareholders have received a dividend equal to that provided for in the preferred contract. A careful study of the court decisions on the point leads me to the conclusion that this is not an accurate statement of the law in all jurisdictions. It is the rule that is followed in some states but it is not the law in others. The point is still unsettled in a majority of the states because it has not come before their highest courts. So far as I have been able to determine, the supreme court of the United States has never had occasion to rule upon it.

A review of the cases on this point discloses the existence of two distinct and conflicting rules both of which are broad enough to include any case where the corporate instruments contain no provision about participation of preferred stockholders in surplus profits. Some jurisdictions permit participation after the common stockholders have received a dividend equal to the preferred while others do not allow such a division of the corporate profits.

Pennsylvania has taken the most definite stand in the matter and the decisions in that state clearly hold that the preferred shareholders may share, pro rata, with the holders of the common stock when excess profits are distributed. The case of first impression, *Fidelity Trust Company* v. *Lehigh Valley Railway Company*, was to the effect that all shares are equal except for the preference stated and that preferred stockholders have all the ordinary incidents of shareholders together with any preference specifically given. For three years the common stockholders had received a dividend equivalent to the ten per cent. paid to the preferred and the remaining surplus available for dividends was divided equally between the common and the preferred at the same rate per share on the par value. Later, however, the surplus was not large enough to pay the ten per cent. cumulative dividend on the preferred, and when a sufficient surplus became available the question arose as to whether the excess paid above the amount of the preference for the three early years could be charged against the preferred arrears of subsequent years. The court decided that it could not be so charged, on the ground that what the preferred had received in the way of dividends with the common in excess of its ten per cent. was a legitimate distribution of profits. Citing no authority the court said that "when each class of stock had been paid ten per cent., they were equal, and equally entitled to distribution of whatever remained in the fund applicable to dividend purposes."

Sternbergh v. *Brock* is the next Pennsylvania decision in regard to preferred participation rights. According to its facts, the preferred stockholders, from 1899 until 1907, received their stipulated dividends and no more, while all profits above these amounts were distributed to the common shareholders who received less than two per cent. on the par value of their stock but more than five per cent. on the amounts which they actually had paid. In March, 1907, a quarterly dividend of two per cent. (a rate of eight per cent. a year) was declared on both the preferred and the common stock. Sternbergh, a common stockholder, filed a bill in equity and claimed that the preferred stockholders were entitled to only five per cent. The contract had no participation provision. The lower court denied the injunction on the authority of the *Fidelity* decision and the case was appealed. In stating the opinion of the higher court, Justice Potter said:

"Where there is no stipulation in the contract to the contrary, the weight of authority clearly favors the right of preferred stockholders to share with the common stockholders in all profits distributed, after the latter have received an amount equal to the stipulated dividend on the preferred stock. In the absence of special provisions, the holders of preferred stock in a corporation are in precisely the same position, both with respect to the corporation itself and with respect to the creditors of the corporation, as the holders of common stock, except only that they are entitled to receive dividends on their shares, to the extent guaranteed or agreed upon, before any dividends can be paid to the holders of common stock."

The supreme court of Pennsylvania, therefore, affirmed the decision of the lower court.

In *Englander* v. *Osborne*, the plaintiff's decedent owned shares of six per cent. cumulative preferred stock in a corporation. No dividends were paid on either the company's preferred or common stock until 1917, a period of nine years, when a dividend of fifty-four per cent., covering the current year and all arrearages, was declared and paid on the preferred, and at the same time a dividend of an equal amount was declared on the common. The plaintiff brought an action to restrain the payment of the latter dividend on the ground that the holders of common stock were not entitled to a dividend of more than six per cent. without sharing the excess equally with the preferred shareholders. On the other hand, the defendants claimed that the holders of common stock were entitled to receive dividends to an amount sufficient to make up arrearages in past years and to equalize the common and preferred stock before the holders of the latter were entitled to receive an excess above the amount of their fixed dividends and arrearages. The lower court restrained the payment of the dividend on the common stock, and the defendant appealed. In giving the opinion of the higher court, Justice Frazer made the following statement:

"We find nothing limiting the right of the preferred stockholders to the six per cent. dividend, regardless of the earnings of the company, and in the absence of such limitation the general rule is that such stockholders are entitled to share with the holders of the common stock all profits distributed after the latter have received in any year an amount equal to the dividend on the preferred stock. The priority of the preferred stockholders rests upon the contract, and beyond the provisions of such contract they occupy no position toward the company different from that of the holders of common stock. When a dividend is declared, the former are entitled to share to the extent of their preference for the current year, and if there remains a sum more than sufficient to pay a similar dividend on the common stock, both classes are entitled to share equally in the excess. In the absence of agreement, expressed or implied, that dividends shall be cumulative, unpaid dividends in the past can not be claimed."

The supreme court concluded that the above principles had been properly applied by the lower court and consequently affirmed its decision.

Indiana seems to be the only other state clearly in line with Pennsylvania on this point. In *Star Publishing Company* v. *Ball*, the supreme court of that state, speaking through Justice Townsend, said: "The preferred stockholder is just as much a party to this venture as the common stockholders, and is entitled to all the rights of the common stockholders, except as modified by statute and contract." After dividends are paid on the common stock equal to those received by the preferred under their contract, the preferred may participate in additional dividends to any amount.

In a Georgia decision, *Coggeshall* v. *Georgia Land and Investment Company*, there is a dictum which conforms to the Pennsylvania rule. In this decision, Judge Wade said:

"Preferred stock takes a multiplicity of forms but usually possesses certain distinctive characteristics. The dividend may be either cumulative or non-cumulative; and unless the contract provides otherwise, preferred stockholders participate in the surplus profits, after the preferred dividend has been declared on the preferred stock, and an equal dividend on the common stock."

In an early English case, the house of lords held that after discharging all debts and liabilities and repaying to the ordinary and the preference shareholders the capital paid on their shares, the assets ought to be divided among all the shareholders in proportion to the shares held. This means, of course, that preferred shareholders would participate equally with the common in any surplus profits in the hands of the company.

Another English decision contains this dictum in the words of Justice Swinfen Eady:

"There is not any rule of law that shareholders having a fixed preferential dividend take that only. It is quite open to a company to distribute its revenue first in paying a fixed preferential dividend; then in paying a dividend of like amount to the ordinary shareholders; and then dividing any surplus revenue of the year ratably between the preference and the ordinary shareholders."

The latest English decision in point involves a company liquidation. In this it was held that where there is nothing in the articles to modify or to exclude the normal right of the preference shareholders to share in the distribution of the surplus assets, they were entitled to rank, pari passu, with the ordinary shareholders in such distribution. Justice Eve made the statement that:

"Nothing is said as to the distribution of any assets still remaining for distribution after the capital has been repaid, but in the absence of any provision to the contrary these assets—the joint result produced by the employment of capital contributed by both classes of shareholders—ought to be shared by the contributors."

Now let us consider the status of stock dividends from the standpoint of preferred participation. If the voting control of the corporation is undisturbed and the right to share in assets upon dissolution is not impaired, and there is no contract to the contrary, the preferred may participate in stock dividends as well as in cash distributions under the Pennsylvania rule. In *Sterling* v. *Watson*, the voting cumulative preferred stock could be retired at the option of the corporation upon the payment of par value and accrued and unpaid dividends. Eight years after a twenty-five per cent. common stock dividend had been distributed equally to both common and preferred stockholders, the company decided to retire the preferred and sought to deduct the par value of the stock dividend from the total amount due to the preferred stockholders under their contract. The court denied the right to make this deduction on the grounds that the contract meant that the preferred dividends must be in cash and that the preferred shareholders were entitled to participate with the common in the stock dividend on the authority of the *Fidelity Trust* and *Sternbergh* decisions. According to Justice Elkin:

"When the preferred dividends are paid, and dividends out of the net earnings from year to year of an equal amount have been declared and paid on the common stock, then all of the stock, common and preferred, has the right to participate in the distribution of the surplus earnings upon an equal basis. . . . The principle is sound and maintained by the great weight of authority."

The original and generally accepted understanding in business and financial circles is that after the preferred stockholders get their specified dividend they are not entitled to participate, and if the rest of the profits are paid out by the corporation in the form of dividends such distributions go entirely to the common stockholders. This is usually called the English rule.

The first time that the question of preferred participation rights appeared before the American courts was in *Scott* v. *Baltimore and Ohio Railroad Company.* According to the report of this case, the preferred certificates provided that the holders should be entitled to such dividends as the directors might declare "up to, but not exceeding, four per centum before any dividends shall be set apart or paid upon the common stock." A preferred stockholder claimed the right to participate in the whole of the surplus remaining after payment of the preference or, failing in that, the right to participate in so much of the surplus as remained for dividends after the common stock had received a dividend equivalent (whether as to rate or amount was not stated in the opinion) to that received by the preferred. The court denied both rights upon the ground that, if the words "not exceeding" did not limit the dividend rights of the preferred stock—if these words did not mean that the holders of preferred stock were entitled to four per cent. and to no more in any circumstances—then the words were meaningless.

The plaintiff in this case contended that the whole purpose of the certificate was to declare what the preferred shareholders were entitled to before the common stockholders were entitled to anything. The language of the certificate is ambiguous, to say the least. It might be taken to mean that no more than four per cent. should be paid to the preferred either before or after any dividends should be set apart or paid on the common, or it might mean that no more than four per cent. should be paid to the preferred until that amount had been paid to the common. Under the first construction, the words "not exceeding" would limit the total amount and under the second there would be no such limitation.

If the express terms of the preferred contract with the corporation, as evidenced by the stock certificate, allocate surplus earnings as a fund out of which such dividends as may be declared must be paid on stock other than the preferred, preferred stockholders are not entitled to participate in surplus earnings in addition to the amount specified in their contract with the corporation. This was the decision in a Virginia case in which the court said:

"Our conclusion, then, is that there is no error in the decree, and that the preferred stockholders . . . are limited to five per cent. dividends in any fiscal year, and can not participate further in the surplus net profits for such year because by their contract they have expressly accorded to all of the other stockholders the paramount and hence exclusive right to have dividends therefrom, subject only to the legal and proper discretion of the board of directors."

In *Keith* v. *Carbon Steel Company*, the court held that a holder of non-cumulative six per cent. preferred stock, who had received his preference dividend in full, was not entitled to restrain the corporation from paying accumulated earnings amounting to nearly half its capital exclusively to the common. According to District Judge Orr:

"The holders of preferred stock must be deemed to have been unwilling to take the same risks as the holders of the common were willing to take. In other words, they were not willing to take their certificates without an expression thereon of the amount which they were entitled, respectively, to receive out of the profits. . . . We are unable to see why, in contracts such as these before us, the expression of the amount to be received under the contract should not be deemed to be an exclusion from the minds of the parties of any additional amount. . . . A certificate of stock does not ordinarily express the share of the profits which a stockholder shall receive from the corporation, and therefore the law implies a term in the agreement that the holder of such certificates shall share equally in the profits set apart by the management for the payment of dividends. There can be no implication, however, where the contract expressly states the percentages which one contracting party is to receive from another."

In two early English decisions are judicial dicta to the effect that profits set apart by directors for depreciation, insurance and improvements go to the ordinary shareholders exclusively, although there are preferred shares entitled to a preferential dividend of five per cent. The court made this statement: "It is generally assumed that where the preference shares are given a fixed preferential dividend at a specified rate that impliedly negatives any right to take any further dividend, and probably this assumption is well founded."

In *Will* v. *United Lankat Plantations Company*, the view is taken that a cumulative preference is a limitation of the total amount. In other words, preferred stockholders are denied the right of participation. According to the facts, the holders of ten per cent. cumulative preferred stock had prior rights over the common as to capital and dividend. The company sold part of its business for cash and 45,000 fully paid shares of the purchasing company. It paid ten per cent. to the preferred stockholders and distributed the shares to the common. A preferred stockholder sued to have the distribution declared illegal on the ground that the preferred should share, pari passu, with the common in excess of ten per cent. on both classes. This case is unique as one of first impression in England. According to Cozens-Hardy, master of the rolls:

> "It is remarkable that, although preference shares have been known for so many years, . . . and although during all those years preference shares . . . have been well known and dealt with in millions, not an instance has been called to our attention in which the claim now set up has been called to our attention."

Justice Joyce of the chancery division allowed the contention of the plaintiff, but the court of appeals unanimously reversed the lower court and expressly held that in the absence of any contrary provision in the statute or contract the preferred was entitled to only the stipulated dividend. On appeal, the house of lords unanimously affirmed this decision.

The decision in the *Will* case apparently is based upon the court's interpretation of the contract, and the following statement occurs in *Palmer's Company Precedents:* "It is generally assumed that where the preference shares are given a fixed preferential dividend at a specified rate that impliedly negatives any right to take any further dividend, and probably this assumption is well founded." Lord Haldane said: "Shares are not issued in the abstract and priorities then attached to them uno flatu, and when you turn to the terms on which the shares are issued you expect to find all the rights as regards dividends specified in the terms of the issue, and when you do find these things prescribed it certainly appears to me unnatural to go beyond them, and look to the general provisions of an article which is only to apply if nothing different is said." Cozens-Hardy, master of the rolls, declared: "One can not be aware to any extent of what goes on in the stock market without knowing that preferential shares of stock are ordinarily spoken of and regarded, and I think properly regarded, as shares of stock which carry a fixed preferential dividend and are entitled to nothing more." According to Lord Justice Farwell: ". . . the birth of preference shares limits in its very inception the whole of its attributes. It has a preference, and such a preference as is given to it by the resolution, and no more; and I should have said that ever since I have been at the bar, or have had anything to do with company matters, that has always been perfectly well understood."

In the case of *Collaroy Company, Limited* v. *Giffard*, the articles provided that "the preference shares shall confer the right to a fixed cumulative preferential dividend. . . ." The court decided that the use of the term "the right" instead of "a right" showed conclusively that it was not intended that the preferred shares should have any right other than the preference.

Canada apparently follows the English rule. In *Ramsay* v. *Steel Company of Canada, Limited*, Justice Orde said:

> "Where the preference shares, duly created and issued, are declared to be entitled to a fixed cumulative preferential dividend at a certain rate per annum, any further participation in the profits of the company is impliedly negatived, and if the right to any further participation is to be granted it must be distinctly so stated."

Cases involving participation rights of preferred shareholders in stock dividends should also be reviewed.

Niles v. *Ludlow Valve Manufacturing Company* is the first decision in point. According to the facts, 4,000 shares of stock were preferred as to eight per cent. dividends and as to capital. In addition, the holders of this stock were entitled to equal voting power with the holders of 3,000 shares of common stock. The statutes of New Jersey, the state of incorporation, provided that the preferred stock should be entitled to a fixed yearly dividend of eight per cent., to be paid before any dividend could be declared on the common stock. Over a period of two decades, in nearly every year, a larger dividend was paid upon the common stock than upon the preferred, but the holders of the latter stock made no protest. The stockholders, common and preferred, authorized the board of directors to distribute from surplus a 100 per cent. dividend of common stock to the holders of the common shares. A holder of preferred, who did not vote for the measure, claimed the right to share in the dividend and sought to enjoin the distribution of it unless the holders of the preferred shares should be allowed to participate. The lower court dismissed the bill. It interpreted the statutes to mean that the preferred shareholders were entitled to eight per cent. and no more and held that the remainder of the surplus available for dividends belonged to the holders of the common stock alone. In affirming the judgment, the circuit court of appeals, speaking through Judge Coxe, said:

"The common shareholders bear substantially all the losses of adversity and are entitled to the gains of prosperity. A contract that they should assume all the risk with no corresponding advantage should be clearly established. We find nothing in the law or the certificate or in the past action of the defendant (the corporation) to indicate that anyone connected with the business supposed that the preferred stockholders were to share equally with the common stockholders in the division of surplus earnings."

Circuit Judge Ward gave the following strong dissenting opinion in the Niles case:

"The general principle is that all stockholders share equally in net profits, except as their relations are altered by statute or contract. If the preference is given to one class of stockholders over the rest, it should be construed consistently with this general principle so far as possible. For instance, if the preferred stockholders are given the right to receive a dividend of a fixed amount before the common stockholders get anything, the latter should receive an equal amount, and then the surplus, if any, be equally divided between the preferred and the common stockholders. Where the privilege is intended to be restrictive, the restriction should be expressed, as by saying that the preferred stockholders are to be paid a certain dividend before the common stockholders get anything and are to receive nothing more. In this case the certificate of the company provided that the preferred stockholders should be paid an annual cumulative dividend of eight per cent. before the common stockholders received anything. There were no words of restriction. Therefore I think that they were entitled to receive their proportion of the stock dividend in question. It is true that the dividends had for many years been declared and paid as if the privilege to the preferred stockholders were restrictive, the question never having been raised, but I think this does not prejudice the rights of the preferred stockholder who now for the first time raises the question."

In *Stone* v. *United States Envelope Company*, a common stockholder sought to restrain a corporation from distributing equally between the common and preferred shareholders a stock dividend representing earnings employed for improvements, claiming that as the preferred had been paid in full, all remaining profits belonged solely to the common. According to the facts of the case, the United States Envelope Company had outstanding 40,000 shares of seven per cent. cumulative preferred stock and 10,000 shares of common, with equal voting power. All of these shares had been issued except 2,500 shares of common, which the corporation proposed to sell at $150 a share to the holders of both classes of stock. This price was less than the value of the stock. Stone, a common shareholder, requested an injunction to restrain the company from selling this stock to the preferred, on the ground that such a sale would have the effect of a dividend. The court refused to allow the preferred to share in the purchase of this stock and thus receive a dividend from the surplus profits of the difference between the value of the stock and its selling price, on the ground that the ordinary buyer of preferred shares buys with the understanding that the maximum of his right to share in dividends is fixed by the fact of preference and at the amount of the preference. According to Justice Deasy: "We put the decision, however, upon the ground that, where nothing to the contrary appears, the creation of the preferred stock prima facie implies that the preferential rights of the (preferred) shareholders are given in lieu of and to the exclusion of the equality of participation which would otherwise exist." After discussing the Pennsylvania rule, the court said: "The other theory which we believe to be better and supported by the weight of authority is that in receiving the greater security of his preferential rights, the preferred impliedly agrees to accept such rights in lieu of equal participation." Justice Deasy then continued with these words: "Independent reasoning as well as what we deem to be the preponderance of authority sustains the plaintiff's position. Words in contracts, as well as in statutes, should ordinarily be construed 'according to the common meaning of the language.' Surely the phrase 'preferred stock' holds out to the ear of the ordinary investor no promise of participation in earnings beyond his preferential dividend. That this is true has been recognized by the authorities." Hence, preferred stockholders, against the objection of common stockholders, can not be given a preemptive right the same as common stockholders to purchase common stock from the corporation at a price less than the value, since this in effect would be an additional dividend to the preferred stockholders.

According to the facts of *Tennant* v. *Epstein*, 356 Ill. 26 (1934), the plaintiff held common stock in an Illinois corporation which had outstanding shares that were preferred as to assets on dissolution and as to dividends to the extent of seven per cent. Under the constitution of Illinois each stockholder, common or preferred, is entitled to one vote for each share held. The board of directors voted a dividend of common stock, one share for each common and each preferred share outstanding. This stock was issued and subsequently a cash dividend was paid on all common stock which, of course, included the stock received as a dividend. The plaintiff asked the cancellation of the stock dividend and the repayment of the cash dividend, and the court granted his request. It seemed that the purpose of the stock dividend was to create a right to additional cash dividends in the holders of the preferred stock. Consequently, holders of preferred stock, which is limited by certificate to dividends of a specified percentage, are not entitled to participate in a stock dividend because such dividend is an indirect way of distributing cash surplus.

According to the facts of *Borg* v. *International Silver Company*, the defendant corporation proposed to issue treasury stock to both preferred and common stockholders at $50 a share, when the par was $100 and the book value probably was more, as the company had accumulated a substantial surplus. The court said: "If it is true—and it appears not to be disputed—that the corporation has a substantial surplus to which the preferred stockholders would not be entitled in the event of dissolution, then the action of the directors in making an offer which results in the preferred stockholders' getting a major portion of the proposed issue at fifty per cent. of its par value, would seem to work an injustice to the common stockholder." The injunction was granted. The rule permitting the preferred stockholders to participate was denounced by the court on the ground that it is unfair to the holders of the common stock who should not be forced to assume a much greater risk than the preferred holders with no better chance for gain.

In *Riverside and Dan River Cotton Mills* v. *Branch*, a surplus was to be distributed in the form of voting shares to the common stockholders. The court decided that the preferred shareholders were entitled to participate in stock dividends beyond the amount of their preference, even though their right to dividends was limited to the preference given. It reasoned that, if the shares were increased and the preferred holders were not allowed to participate, the value of their rights upon dissolution would be decreased. Since the preferred had equal voting power with the common, an increase in the number of shares would decrease the proportionate strength of the preferred stockholders in the control and management of the corporation if they were not given a proportionate part of the shares distributed. Justice Chichester made the following statement in delivering the opinion of the court:

". . . When there are two kinds of stockholders, one preferred and the other common, when there is no difference in their status under the corporate charter except a preference as to dividends, and none under the statute law, the sale of stock to common stockholders at par, without giving the preferred stockholders an opportunity to purchase their proportionate part under the same conditions, or the issuance of a stock dividend to the common stockholders to the exclusion of the preferred stockholders, is an impairment of the rights of the latter which entitles them to relief in equity if the stock has not been delivered, or to damages for breach of a contract obligation if it has."

The English rule that preferred stockholders are entitled to their contractual dividend and no more where there is no provision to the contrary has been carefully considered and solemnly adopted by several courts in the United States, as well as in England and by at least one court in Canada as the better view. Aside from authority, it is believed that it conforms more nearly to business notions than the other rule. The common stockholders expect to receive the greater share of the corporation's profits. If it were not for this they would be unwilling to assume the risk involved in subscribing to common stock. To permit the holders of preferred stock to share pro rata in the surplus is to give them identical benefits for a smaller consideration because, on account of their stipulated dividend, they bear less risk than the common. It is highly unreasonable that the holders of the common stock should bear all the losses of lean years and that the preferred should enjoy pro rata the surplus earnings of prosperous years. The corporation grants the preference to the preferred stockholders in return for giving up the right to further dividends after the specified dividend has been paid. If participation is intended, it may be provided for by the contract. Absence of such provision should be construed as a denial of the right.

The participation rights of preferred stockholders, in the absence of a provision in the contract, is a question that has come before few of our state supreme courts. Since so few cases on the point have been adjudicated, it is uncertain what view any particular court will take of it, unless one of the precedents is, in the opinion of the court, precisely in point and binding upon it. Since the English rule is supported by reason and by weight of authority in this country, in England and in Canada, it probably will be given careful consideration when the question arises in states that as yet have no precedents on the point.